AMERICAN ACADEMY of ACTUARIES

MEMORANDUM

To: NAIC Life and Health Actuarial Task Force

From: Academy Nonforfeiture Improvement Work Group

Subject: Report on General Nonforfeiture Revision

Date: 03/11/04

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The Nonforfeiture Improvement Work Group of the Academy of Actuaries has been evaluating possible revisions to the Standard Nonforfeiture Laws since March 2003. We initially identified the need for revision, particularly as it could make available a broad array of more flexible and consumer-oriented policy designs. This was the content of a report to LHATF on June 19, 2003. Subsequently, in a report on September 12, 2003, we indicated that we were proceeding in parallel along three key paths--the identification of underlying principles for revised laws, the development of a structure for the laws, and identifying Federal Income Tax issues that might affect any revisions. We have found that the Federal Income Tax considerations have raised significant questions concerning our future direction. As a result, we are seeking your guidance concerning our future activities.

Background

The June report indicated that various types of product flexibility to meet consumer needs could be facilitated by changing constraints that exist within current nonforfeiture law structure. Possible new designs that could be made available included:

Products with guaranteed cash values below what is currently allowed

- no-cash-value permanent life insurance
- straightforward no-cash-value term insurance
- life insurance policies with non-smooth cash values
- life insurance with nonforfeiture interest rates periodically reset
- "Cash value plan" life insurance

Multiple benefit policies

- multi-line universal insurance
- multi-generational family policy
- life cycle insurance

Market value adjusted life insurance

- market value adjusted life insurance

We also recognized that revision could address some additional areas of interest to regulators, namely, introduction of consistency of requirements across product types and the elimination of contrived product structures that are sometimes used to mold a policy to consumer needs.

Federal Income Tax Issues

The operation of life insurance is closely intertwined with Federal Income Tax laws and regulations that address eligibility for deferral of taxation on the policyowner and requirements for reserve deductions. Because it is considered important to maintain favorable tax treatment of life insurance and because this is complicated by the political nature of the setting of tax policy, we enlisted four life insurance tax specialists to evaluate the Federal Income Tax implications of the various types of changes that we were contemplating. They indicated that there are reasonable justifications for current tax treatment; however, some of the product designs that could be introduced with nonforfeiture law revision could erode the justifications and place the favorable tax treatment at risk. In particular, they observed:

- No-cash-value permanent life insurance could risk the loss of tax deferral on inside buildup.

- No-cash-value term insurance would seem to pose no problem, provided it is term insurance for a limited period. To the extent term insurance gets lengthened to the point of effectively creating no-cash-value permanent insurance, there would be the same risk as with no-cash-value life insurance.

- Life insurance with non-smooth cash values could present some risk, although it may be less than with no-cash-value insurance. An additional concern is the possibility of accommodating a "springing cash value" product, an area previously addressed by the IRS.

- Life insurance with nonforfeiture interest rate periodically reset does not seem to introduce tax problems.

- "Cash value plan" life insurance could bring the same risk as no-cash-value permanent life insurance.

- Universal insurance would not bring tax risk.

- Multi-generational family policy would not bring tax risk.

- Life cycle insurance would bring little risk to the deferral of taxation on inside buildup.

- Market value adjusted life insurance would not bring tax risk.

The potential designs that permit optional cash value structures all bring risk of a challenge to the tax deferral on inside buildup. This raises the question of whether the scope of general nonforfeiture revision should be changed.

Consideration of Project Scope

The tax treatment risks suggest that thought should be given to the scope of the product flexibility that is sought. However, the tax risks have little impact on the additional benefits of nonforfeiture law revision that might be of interest to regulators. This leads to the consideration of three possible directions to take:

A. Continue on the initial path and pursue a broad revision of nonforfeiture laws without any curtailment. The tax risks would be dealt with as they surfaced.

B. Narrow the scope to exclude components that may bring significant risk to the current tax status of life insurance.

C. Defer general nonforfeiture revision until a time when the balance between benefits and risks is more favorable.

The members of the Nonforfeiture Improvement Work Group are split in their thoughts on future direction, with a majority favoring approach ‘A’ and a significant minority favoring approach ‘C’. We solicit your guidance on what direction you would like us to take.